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ABSTRACT

This document, prepared by the Texas State Auditor's Office, offers detailed guidelines for conducting a financial audit of community colleges in Texas. Its purpose is to assist governing boards and college management in ensuring that their colleges are receiving high-quality opinion audits on annual financial statements. The guide includes the following information: Recommendations for good business practices in the annual financial statement opinion audit process--in particular, for procuring audit services; descriptions of each participant's responsibilities in the audit process; and a general description of the audit process. The guide suggests that community colleges use an audit committee, which is a liaison between the full board, management, and the internal and external auditors. The four critical elements of procurement practices for audit services are: (1) competition; (2) solicitation; (3) technical evaluation; and (4) written agreements. It is crucial to monitor the results of the audit as it progresses. The report also outlines the responsibilities of external auditors, as well as general audit standards, which include qualifications, independence, due professional care, and quality control. Ten steps in the annual financial statement opinion audit are identified, beginning with the plan for the procurement of audit services and concluding with resolution of the audit. (Contains 11 references for further guidance.) (NB)

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Financial Statement Opinion Audit Guide for Texas Public Community Colleges

1999

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Report 99-020
March 1999

OVERVIEW

What is the purpose of this guide?

The purpose of this guide is to help governing boards and college management ensure that their Texas public community colleges receive high-quality opinion audits on annual financial statements. In its review of community college annual financial statements since 1994, the State Auditor's Office (Office) found indications that some institutions were not receiving high-quality audits. These indicators included fund balances that did not tie between fiscal years, inappropriate uses of fund accounting, numerous instances of reporting noncompliance, and inappropriate classifications of accounts.

This guide includes the following information:

- Recommendations for good business practices in the annual financial statement opinion audit process, in particular, for procuring audit services
- Descriptions of each participant's responsibilities in the audit process
- General description of the audit process

Rather than duplicate the efforts of other authoritative literature, this guide presents information at a summarized level. A list of more detailed resources appears in the appendix.

This guide also satisfies part of the General Appropriations Act, 75th Legislature, Article III-49, Item 26(b), which reads as follows:

> The State Auditor's Office (SAO), in consultation with the Coordinating Board, shall develop a guide explaining the independent audit process and what each board should expect from its auditor. The guide shall require local boards to require their independent auditors to contact both the Office and the Coordinating Board's Community and Technical Colleges division during the audit planning process. Both agencies shall be prepared to inform auditors of areas of potential risk that shall be addressed during the audit.

How can community colleges help ensure they receive a high-quality audit?

The Office recommends that public community colleges consider implementing the following good business practices:

- Use an audit committee to help their governing boards fulfill their responsibilities to their constituents, the State, and other parties. In 1987, the Treadway Commission began advocating the use of audit committees to assist management and governing boards. The Government Financial Officers Association also recommends the use of audit committees for all governing bodies. The audit committee is a liaison between the full board, management, and the internal and external auditors (see Section A).

- Carefully assess their procurement practices for audit services and incorporate the four critical elements (competition, solicitation, technical evaluation, and written agreements) of an effective process as identified by the United States General Accounting Office (see Section B). By incorporating these elements, community colleges can significantly increase the probability that they will receive a high-quality audit, according to a United States General Accounting Office (GAO) study. This study indicated that if they used effective procurement methods, institutions received an audit that met quality standards 83 percent of the time. Conversely, if they did not use an effective procurement process, they received an audit that did not meet quality standards 46 percent of the time.

- Monitor the results of the audit as it progresses. Even when colleges use sound procurement processes, they should monitor the auditors' progress to ensure that the external auditors fulfill their contractual obligations and the college receives a high-quality audit (see Section C).

Increased use of audit committees, inclusion of the four critical factors during the procurement cycle, and continued monitoring throughout the audit should result in community colleges receiving higher-quality audits. This will increase accountability within the governing boards, colleges' management, and the external auditors.

Both the governing boards and colleges will have the benefit of better information arising from the audits. They in turn should use this information to improve the policies and procedures to achieve the specific objectives of the college.

Although this guide provides information about the annual financial statement opinion audit process, management may also consider procuring additional audit services, either internally or externally, to identify opportunities to improve efficiency. Other types of audits include performance, efficiency, compliance, and investigative audits.

Section A:

Responsibilities in the Audit Process

1999 Edition
State Auditor's Office

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Responsibilities in the Audit Process

Governing Boards and Audit Committees

What are the responsibilities of the governing board?

The governing board is ultimately accountable for the college's public funds, according to the Texas Education Code, Chapter 51, Section 352 (e). To meet this obligation, the board should ensure that the college's annual financial statements accurately represent its financial position and operations.

- The board usually relies on the college's management to prepare annual financial statements.
- The board usually relies on internal and external auditors to ensure that the information in the statements is reliable and fairly presented.
- The board can rely on an audit committee to help fulfill its numerous duties.

Although the board may rely on these other parties to assist them in their duties, board members are elected to provide effective oversight to the college. Therefore, the board should not forget that they are responsible for the content of the college's financial statements.

What are the benefits of an audit committee?

According to *Audit Committees for State and Local Government*, published by KPMG Peat Marwick, the primary benefit of a vigilant and informed audit committee is the assistance it provides to a full governing board in its responsibility for the fair presentation of an institution's annual financial statements. However, the audit committee provides services and benefits to several parties including the board, management, internal and external auditors, taxpayers, and creditors.

With an audit committee, the board can make better use of its limited time and resources. The audit committee performs many financial functions (such as reviewing the annual budget and approving capital improvements) and provides the full board with the information it needs to carry out its financial responsibilities.

An audit committee can also assure the board of the status of financial operations and the related control systems. The audit committee may review internal controls to determine if they are effective and determines if the auditors' recommendations for improvements receive proper attention.

Management can communicate to the full board better through an audit committee. Management can effectively discuss its financial plans and purpose to the full board when a portion of the board is already familiar with the college's financial matters. Management can discuss complex financial issues directly and in detail with the audit committee with the confidence that it will keep the board informed.

External auditors work more efficiently with an audit committee. With an audit committee actively overseeing the audit function, the external auditors' independence is enhanced and they are shielded from inappropriate management influences. Audit committees improve cooperation between the auditors and management and increase the auditors' knowledge of the board's concerns.

Internal auditors often find that board and management support for their work and recommendations increases as a result of working with an audit committee. This support increases the professionalism and independence of internal audit functions. Furthermore, assurance that internal audit results are being reviewed and considered for implementation promptly can improve the morale of the internal auditors, accelerate the implementation of

recommendations, and encourage the cooperation of the departments being audited. Because the public can see that the audit committee provides active oversight to the college, taxpayers and creditors (bondholders) are assured that the board is functioning in their best interest. The governing board, in addition to the audit committee, should also provide oversight. However, by having an audit committee, the board can provide for more specialized and complete oversight of the college's financial management.

How does a governing board establish an audit committee?

In their book, *Working with the Audit Committee*, Barbara Apostolou and Raymond Jeffords outline procedures for establishing an effective audit committee. A governing board usually creates an audit committee through a resolution or by amending its bylaws. The board should also provide the committee a written charter that documents the committee's role, objectives, duties, and responsibilities. The audit committee's duties should be defined broadly enough to include special inquiries and investigations within the committee's scope of activities. Even if a board has an audit committee, the members are not discharged from their fiduciary responsibility for the proper management of the college.

Who should serve on the audit committee?

The membership of the audit committee should attempt to fulfill two goals:

- The committee's members should have the technical expertise that the full board needs to fulfill its responsibilities.
- The committee should ensure that the financial audit is independent of management in both fact and appearance.

Not all audit committee members need to be elected to the board. If the governing board wishes, it is acceptable to bring citizens from the community onto the committee to increase the level of skills and technical expertise.
The size of the committee should be tailored to the needs of the board; audit committees usually include three to five members with financial backgrounds, if possible. Apostolou and Jeffords suggest including at least one certified public accountant and one lawyer to assist with financial and legal questions. The full board should decide the number of committee members it needs. A smaller number of members is generally more efficient, but a larger number may provide different perspectives necessary for solving problems.

How long should members serve on the audit committee?

Audit committee members should serve for multiple years, and their terms should be staggered to provide continuity. Typically, since new members must first become oriented to their new assignments, their later years are more productive. Therefore, a multi-year term may provide more years of productive service. If terms become too long, however, there is a danger that the committee may not have an influx of fresh perspectives each year. When determining the length of service, the board should keep in mind the balance between the learning curve of new members and the new views they provide.

How often should the committee meet?

Typically, an audit committee will meet several times a year depending on its activities. However, if the audit committee has other concerns, especially regarding the financial health of an institution, this number may increase. Therefore, it is up to the committee to determine how frequently it needs to meet to

fulfill its duties. In any case, the audit committee should be very involved in the audit cycle as a representative of the governing board. Meetings may also be necessary throughout the year to review internal audit activities or other board concerns.

What is the audit committee's role in the annual financial statement opinion audit process?

Traditionally, the audit committee selected the external auditors to audit the college's annual financial statements and review the auditors' scope, opinion, and any problems with management. If the governing board decides not to implement an audit committee, then these responsibilities fall to the full board. In recent years, an increasing demand for greater organizational accountability has expanded the governing board or audit committee's role.

According to the United States General Accounting Office's report *CPA Audit Quality: A Framework for Procuring Audit Services* (August 1987) and *Audit Committees for State and Local Government*, by KPMG Peat Marwick, the following activities are common for a governmental audit committee:

- Select the external auditors.
- Review the audit plan with the external auditors.
- Monitor the progress of the audit.
- Review the audited annual report and audit results. (This is the audit committee's most important task.)
- Present the audit report to the board.
- Perform additional duties as necessary.

Select the external auditors. The external auditors give an opinion on the accuracy of the college's annual financial statements (see Section C). This helps the board fulfill its accountability to its stakeholders. The audit committee should:

- Work with management to plan the procurement for audit services and identify potential bidders.
- Participate in evaluating audit firms using pre-established technical factors.
- Actively oversee the procurement process.

Review the audit plan with the external auditors. Annually reviewing the audit plan with the external auditors helps the audit committee fulfill its responsibility to oversee the nature and scope of the annual audit. The audit committee should also review any problems the auditors expect and the procedures designed to resolve them. Although the plan must be based on the auditors' professional judgment, most audit committees are interested in the basis for the auditors' judgment and the extent of audit work planned. Many audit committees devote a full meeting with the auditors to review the audit plan.

Prior to the meeting, the audit committee should request a summary of the audit plan so that it can discuss the following points:

- Type(s) of audit(s) to be performed such as financial, compliance, single (federal), performance, economy and efficiency, management control, and/or program results
- Extent and timing of the auditors' proposed coverage
- Timing and nature of specific procedures to be performed
- Extent of planned reliance on the work of the internal audit staff
- Assistance management will provide in the initial preparation of audit working papers
- Review of automated systems

- Use of computer auditing and statistical sampling techniques
- Impact of new or proposed changes in accounting principles, regulations, or financial reporting practices
- Types and formats of statements to be issued
- Potential restrictions on audit scope and other matters that could affect the auditors' opinion
- Other significant problems that the auditors can foresee and how they will be handled

After reviewing the audit plan, the audit committee may request that the auditors perform additional work or make a more comprehensive review of the internal control structure, depending on specific areas of concern.

Monitor the progress of the audit. The audit committee should monitor the progress of the audit to ensure that it is completed within required time frames. The time frames can be internally designated (as in a contract deadline) or externally required (as specified by statute or regulation). Even if there are no time restrictions, audit results should be communicated in a timely manner. Periodic monitoring by the audit committee will help ensure that the audit is completed on time and reports are used without delay.

Review the audited annual financial report and audit results. The most important task of the audit committee is to review the results of the audit (such as management comments) and the audited annual financial report (AFR). This review should include discussions with management and the external auditors. It should occur close to the auditors' projected completion date and before management plans to issue the AFR. Such timing is necessary to give the audit committee sufficient time to consider problems.

According to KPMG Peat Marwick's *Audit Committees for State and Local Government*, the audit committee should discuss the following items in the review:

- Unresolved accounting and auditing problems
- Significant adjustments, reclassifications, or additional disclosures the auditors propose
- Material errors or irregularities or possible material illegal acts
- Adequacy of annual financial statement disclosures and compliance with applicable statutes and regulations
- Changes in accounting policies or principles during the year
- Disagreements with management on financial accounting and reporting matters and auditing procedures that, if not satisfactorily resolved, would have caused the issuance of a modified opinion (not a clean or unqualified opinion) on the annual financial statements
- Reasons for major year-to-year fluctuations in annual financial statement balances
- Unusual circumstances or situations reflected in the annual financial statements
- Nature and reasonableness of the underlying assumptions and estimate of management accounting and disclosure considerations associated with material contingencies
- Significant changes in the format of the annual financial statements (compared to previous years) or significant differences in format between the college's presentation and the presentations of similar community colleges (financial statement presentation guidelines for Texas public community colleges are established by the *Annual Financial Reporting Requirements for Texas Public Community Colleges*, promulgated by the Texas Higher Education Coordinating Board)

- Material weaknesses in internal accounting control

- Recommendations in the auditors' letter to management for improving the accounting and internal control systems and the status of action on previous recommendations

Present the audit report to the board. If the board has a separate audit committee, then following the review of the AFR and management letter, the audit committee should present the reports to the full board, with assistance from the external auditors as necessary. The presentation should help the non-financially oriented board members better understand the information contained in the AFR and highlight data that is particularly pertinent to the full board's decision-making needs.

Presenting useful information to the full board is key function of audit committees. The board cannot benefit from the audit committee's efforts unless the committee presents all the important points and findings clearly. An effective presentation can increase the board members' knowledge and assist them in fulfilling their responsibilities and contributing to the taxpayers' interests.

Perform general responsibilities. In addition to the above functions, audit committees often have the following responsibilities:

- Oversee the internal audit function and review or approve the annual internal audit plan.

- Receive periodic status reports from the chief internal auditor on internal audit activities including accomplishments of the annual plan, major deviations, and significant audit findings.

- Understand the nature and complexity of institutional operations.

- Grasp any technical problems the college might encounter in applying generally accepted accounting principles (GAAP).

- Comprehend accounting principles applicable to the college.

- Review the procedures followed by internal and external auditors.

- Identify difficulties or problems in complying with regulatory agency requirements.

- Report to the full board on the adequacy of internal control over financial and administrative transactions.

- Ensure that matters of noncompliance with institutional policies, generally accepted accounting principles (GAAP), regulations, and laws are resolved.

For more information on audit committees, refer to these resources:

Apostolou, Barbara, Ph.D., CPA and Raymond Jeffords, Ph.D., CPA, *Working with the Audit Committee,* **The Institute of Internal Auditors, Altamonte Springs, FL., 1990.**

KMPG Peat Marwick, *Audit Committees for State and Local Government,* **Peat Marwick Main & Co., U.S.A., 1988.**

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Management of the College

What are the responsibilities of the college's management?

The governing board has ultimate responsibility for the reliability of the annual financial statements. However, it will typically delegate its authority to prepare the annual financial statements and operate the college appropriately to the college's management.

Management must prepare the annual financial statements so that they fairly present the results of the college's financial position and operations according to generally accepted accounting principles.

This discussion focuses on management's role within the annual financial statement opinion audit, but it also outlines management's general responsibilities.

What are management's general responsibilities?

The management of a Texas public community college has a fiduciary duty to the State of Texas, the governing board, the faculty and students, and taxpayers in the district to use the resources it is entrusted with appropriately. Therefore, management should:

- Adopt sound accounting policies.
- Maintain an adequate and effective system of accounts.
- Safeguard assets.
- Establish and maintain a system of internal controls that will, among other things, help ensure the production of proper annual financial statements. (See Figure 1 for the elements of an internal control environment.)

Figure 1

Establish a System of Internal Control

Management is responsible for establishing internal controls to safeguard assets, ensure accurate accounting data, further institutional effectiveness, and encourage adherence to managerial policy. The following are components of internal controls:

Integrity, ethical values, and competence - Integrity and ethical values must be practiced at all levels of the organization and staff must be competent.

Control Environment - The institutional environment must be conducive to internal control.

Objectives - Objectives and related implementation strategies must be established for the institution as a whole, as well as for significant activities.

Risk Assessment - Risks related to achievement of the objectives should be identified and analyzed.

Information Systems - Information requirements must be identified and systems put into place to provide needed information.

Control Procedures - Control procedures must be in place to ensure adherence to policies and to address risks related to the achievement of objectives.

Communication - Communication paths must allow relevant messages and information to travel in any direction.

Managing Change - Change affecting the institution's ability to achieve its objectives must be identified and responded to in a timely manner.

Monitoring - Internal controls must be monitored and policies and procedures must be modified as necessary.

Source: Committee of Sponsoring Organizations of the Treadway Commission (COSO)

It is management's responsibility to determine how to correct problems within the internal control structure. During the annual financial statement opinion audit, the external auditors must assess the college's internal control structure to plan and conduct the audit.

Although a college may receive an unqualified opinion because its annual financial statements are materially accurate, it is still possible that the internal control structure is not effective. However, external auditors are required to inform management about any internal control deficiencies identified including material weaknesses.

What are management's responsibilities in the annual financial statement opinion audit process?

Management's responsibilities in the annual financial statement opinion audit process are to:

- Prepare the annual financial statements.
- Make assertions about the annual financial statements for the external auditors to test.
- Record their representations so that the external auditors can render an unqualified opinion.

Prepare the annual financial statements. The annual financial statements are the responsibility of the college's governing board and management. Management prepares the underlying data from which the annual financial statements are derived. (This preparation includes analyzing, recording, posting, and preparing adjusting and closing entries). Management should also prepare the annual financial statements according to the annual reporting requirements promulgated by the Texas Higher Education Coordinating Board.

The external auditors may help draft the annual financial statements or suggest changes in presentation. However, management must decide whether to accept these suggestions. According to the General Accounting Office's second general standard (see Independence under External Auditor), the external auditors' independence may be impaired if they perform a substantial part of the accounting cycle.

During the course of fieldwork, the auditors may propose adjustments to the annual financial statements. Management should consider whether to make and book these adjustments in its accounting systems. Although management is not required to make proposed audit adjustments, the auditors may not be able to render an unqualified opinion otherwise.

The college is required to prepare the basic financial exhibits, notes to the annual financial statements, and supporting schedules as required by the Texas Higher Education Coordinating Board at a minimum. Based on its informational needs, the college may wish to prepare comprehensive annual financial statements. These statements include the basic requirements of the Texas Higher Education Coordinating Board's reporting requirements, but include a greater level of financial detail and statistical data.

Make annual financial statement assertions. Management makes several assertions in the annual financial statements that the external auditors must test to determine if the assertions are supported. Assertions are representations by management that the components of the annual financial statements are accurate. (AICPA Professional Standards, Section 326.03, *Evidential Matter*, and 326.08, *The Standards of Field Work*),

They can be either explicit or implicit and are classified according to the following broad categories:

- Existence or Occurrence - Management asserts that assets and liabilities of the institution exist at a given date and recorded transactions have occurred during a given period.
- Completeness - Management asserts that all transactions and accounts that should be presented in the annual financial statements are included.

- Rights and Obligations - Management asserts that the college has rights to the assets and obligations for the liabilities listed at a given date.

- Valuation and allocation - Management asserts that asset, liability, revenue, and expense components have been included in the annual financial statements at appropriate amounts.

- Presentation and disclosure - Management asserts that particular components of the annual financial statements are properly classified, described, and disclosed.

If the external auditors find that the annual financial statement assertions issued by management are supported, they can issue an unqualified opinion.

Record management representations. During the course of the audit, the external auditors must obtain written representations from management according to generally accepted auditing standards (*Statement of Auditing Standards No.19*). Without management's written representation, the external auditors cannot render an unqualified opinion. Management's representations can differ from one audit to the next, but generally include the following:

- Management accepts that the fair presentation of the annual financial statements is its responsibility.

- Management believes that the annual financial statements comply with generally accepted accounting principles.

- Management made all financial records and related data available to the external auditors.

- Management believes that no significant misstatements or unrecorded transactions exist in the annual financial statements.

- Management disclosed all related party transactions.

- Management believes that all component units have been included in the annual financial statements.

- Management properly classified funds.

- Management complied with budget ordinances.

- Management complied with grant requirements.

- Management disclosed all significant information subsequent to the balance sheet date.

- Management disclosed all litigation that may have a material effect on the annual financial statements and have a reasonable possibility of being judged unfavorably against the institution, according to counsel.

Management should have direct knowledge and control over the transactions reflected in the accounts and in the annual financial statements. However, since the external auditors only know about the transactions through their examination, they must rely on the fairness of management's representations in forming their opinion. The external auditors may help draft the annual financial statements or suggest changes in presentation, based upon management's accounts and records. However, the responsibility for the statements they have examined is limited to the expression of their opinion. The annual financial statements remain the representations of management and are its responsibility (paragraph 110.02 of *Statement* of *Auditing Standards No. 1*).

For more information on general accounting and reporting guidance, refer to the following sources:

Annual Financial Reporting Requirements for Texas Public Community Colleges, **Texas Higher Education Coordinating Board, Austin, Texas.***

Codification of Governmental Accounting and Financial Reporting Standards, **Governmental Accounting Standards Board, Norwalk, CT, 1998.***

McDonald, Deirdre (ed.), *College and University Business Administration*, **National Association of College and University Business Officers, Washington, D.C., 1992.**

* **These resources are published on a periodic basis. The governing board, college, and external auditors should ensure they are using the latest version available.**

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External Auditors

What are the responsibilities of the external auditors during the annual financial statement opinion audit?

The external auditors have three main responsibilities:

- They must render an appropriate opinion as to whether the annual financial statements are fairly stated. The auditors' opinion helps those not directly involved with the college understand the college's financial situation.

- They must ensure that the annual financial statements do not materially deviate from the Texas Higher Education Coordinating Board's annual reporting requirements. However, it is the college's responsibility to prepare the statements according to these guidelines.

- They must conduct the audit in accordance with requirements created by oversight bodies. The United States General Accounting Office (GAO) and the American Institute of Certified Public Accountants (AICPA), along with other oversight institutions, establish requirements for conducting audits of governmental institutions. Audits of governmental institutions should be conducted according to generally accepted governmental auditing standards (GAGAS) and generally accepted auditing standards (GAAS). Guidance on annual financial statement audits of public community colleges can be found in the AICPA's *Audits of Colleges and Universities* and *Audits of State and Local Governmental Units*.

Why have audit standards?

Since 1985, both the GAO and the AICPA have cited concerns about the quality of audits for governmental institutions. Reports from both bodies indicated that external auditors' failure to comply with professional auditing standards resulted in poor quality audits. The audit standards provide a benchmark to ensure that auditors conduct quality engagements.

These standards for conducting financial and performance audits are divided into three groups:

- General standards
- Fieldwork standards
- Reporting standards

The standards are designed to build on each other and should be interpreted together rather than individually.

What are the general standards?

General standards are distinct from both fieldwork and reporting standards. The general standards establish requirements for the auditors' overall work. These standards are divided into four categories:

- Qualifications
- Independence
- Due professional care
- Quality control

Qualifications

The staff members assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required.

For audits that lead to an opinion on the reliability of an institution's annual financial statement, the external auditors should be licensed certified public accountants (CPAs) or should work for a licensed public accounting firm. Further, the individual auditor or auditing organization must be *collectively* proficient in

accounting, auditing, and any special specific or unique environment under which the audited institution operates. It does not matter how skilled the auditor is in related fields such as business, finance, or computer systems. Because each member of the team may have specific knowledge of an area relating to the audit, it is not necessary for any *single* auditor on an audit team to know *all* the details of the institution being audited.

For Texas public community colleges, the auditor or audit team should be collectively proficient in each of the following fields: general accounting and auditing, Texas government accounting and auditing, and Texas community college financial reporting and operations.

Although this knowledge is initially obtained through formal education and on-the-job experience, continuing professional education (CPE) is a key element in maintaining an auditor's skill. GAGAS require every auditor complete at least 80 hours of CPE every two years. At least 20 hours must be completed each year. All CPE hours must contribute to the auditor's professional proficiency.

GAGAS also require auditors responsible for planning, directing, and conducting fieldwork or preparing the audit report to participate in specific types of continuing education and training to maintain their technical skills. Therefore, 24 of the 80 required hours should be directly related to the type of specific or unique environment in which the auditor operates. According to standards, auditors who audit Texas public community colleges must ensure that 24 of their 80 hours of CPE relate directly to the environment in which these colleges operate.

To ensure that its team is in compliance with *Government Auditing Standards*, the auditors should provide the college with a list of the auditors who will be conducting the audit. The list should contain the auditors' titles, experience levels, any areas of specialization, and CPE hours with course names.

Independence

In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.

Auditors and the entire audit organization should maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and be viewed as impartial by knowledgeable third parties. In auditing, independence implies an obligation of fairness and fiduciary responsibility to management of the audited institution, stakeholders, and others who rely upon information in the report. For Texas public community colleges, these include the state government, the Board of Directors, bondholders, students, and other citizens of the State of Texas.

To be considered independent, the auditors must be *recognized as independent* by the public. Therefore, the auditors should be free from any obligation to or interest in the audited institution, its management, or its stakeholders.

Independent auditors should be independent in fact, in political views, in their attitudes and beliefs, and in their situations. Auditors are relied upon because the public accepts their professional integrity as an assurance that they will use their skills and knowledge to the fullest and place the interests of the audited and the public ahead of their own.

The external auditor should take care not to impair independence by performing substantial accounting functions for the institution. These functions can include analyzing, recording and preparing adjusting and closing entries). Although auditors commonly help draft the annual financial statements, the annual financial statements are still the responsibility of management. External auditors should take care not to audit their own work.

Due Professional Care

Due professional care should be used in conducting the audit and in preparing related reports.

The concept of due professional care imposes a responsibility upon each auditor to observe GAAS. Exercising due professional care means using sound judgment in establishing and implementing the audit scope (what is to be audited), methodology (steps the auditors will follow), analyses (tests to be performed), evaluations, and reports. This concept includes determining what standards are applicable in various situations and what justifies using or not using them.

While each auditor and each audit organization should exercise due professional care in the performance of audits, this does not imply unlimited responsibility or infallibility on the part of either the individual auditor or the audit organization.

Quality Control

Each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external quality control review.

The internal quality control system established by an audit organization should provide reasonable assurance that it:

(1) Has adopted, and is following, applicable auditing standards

(2) Has established, and is following, adequate audit policies and procedures

GAGAS go beyond GAAS and require independent auditors to participate in an external quality control review program at least once every three years by a third-party organization. For Texas public community colleges, this means that the auditors or audit organization used to audit the college should undergo a review of its internal quality control system at least once every three years. Results of the audit should verify that a quality control system is in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed.

In order for a Texas public community college to ensure that its auditors are in compliance with *Government Auditing Standards*, they or the auditing organization should provide the college with its most recent external quality control review report.

What are the fieldwork standards?

GAO fieldwork standards require independent auditors to do the following three things:

- The auditors must adequately plan the audit and supervise assistants. To ensure that the audit is effective and efficient, the auditors must determine where to commit audit resources. In planning for an audit, the auditors should gain an understanding not only of the institution to be audited, but of the environment it operates in. The auditors should also review the *Annual Financial Reporting Requirements for Texas Public Community Colleges*, developed by the Texas Higher Education Coordinating Board, each year. These requirements provide guidance on presentation and accounting treatments for the annual financial statements of public community colleges.

- The auditors must also develop an understanding of the internal control structure of the audited institution that is sufficient to plan the audit. To do this, the auditors should examine the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessments. Any internal control deficiencies that could result in

material misstatements in the annual financial statements should be reported to the governing board, preferably in writing. If internal control weaknesses are less significant, they should be communicated to the institution's management.

- The auditors must obtain sufficient and competent evidence to support their opinion. This evidence should be comprehensive enough to allow an experienced auditor, with no previous connection to the audit, to draw the same conclusions.

By following these standards, the auditors help ensure that their audit results in an appropriate opinion.

What are the reporting standards?

In addition, the AICPA established four reporting standards, which are incorporated by GAGAS, that the independent auditors' report must follow.

These standards require the auditors' report to:

- State whether the annual financial statements are in conformity with generally accepted accounting principles.
- Identify situations where such principles have not been consistently followed.
- Identify where information disclosures in the annual financial statements are not adequate.
- Either express an opinion on the annual financial statements as a whole or explain why such an opinion cannot be expressed.

In addition to the above reporting standards, the GAO has prescribed these additional reporting requirements:

- The auditors must inform the audit committee of their responsibilities in an annual financial statement audit, including the responsibility to test and report on internal controls and compliance with laws and regulations. The auditor should also communicate the nature of any additional testing of internal controls and compliance required by laws and regulations. This communication can be verbal or written but should be documented.
- The auditors must state that they conducted the audit according to generally accepted government auditing standards.
- The auditors' report should describe either the scope of the auditors' testing for compliance with laws, regulations, and internal controls or refer to separate reports containing this information.
- The auditors must disclose whether information is omitted from the report because of legal restrictions.
- The auditors' report should be submitted to the appropriate officials in the audited institution, officials with oversight responsibilities, and to any other people authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection.

The auditors are responsible for ensuring any audit work they undertake complies with these requirements.

For more information on auditing standards, refer to following sources:

Audits of Colleges and Universities, American Institute of Certified Public Accountants, New York, NY, 1998.

Audits of State and Local Governmental Units, American Institute of Certified Public Accountants, New York, NY, May 1995.

Government Auditing Standards, United States General Accounting Office, U.S. Government Printing Office, Washington D.C., June 1994.

Codification of Statements on Auditing Standards, American Institute of Certified Public Accountants, New York, NY, 1998. *

* This publication is updated often. The governing board, management, and the external auditors should ensure that the latest version is being used.

Section B

Effect of Procurement Processes on Audit Quality

1999 Edition
State Auditor's Office

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Effect of Procurement Processes on Audit Quality

Procurement Processes and Audit Quality

How does a college's procurement process affect the quality of its audit?

In August 1987, the United States General Accounting Office (GAO) released a report that established a link between the procurement practices an entity used and the quality of the audit it received. The GAO review, *CPA Audit Quality - A Framework for Procuring Audit Services*, indicated that entities using an effective procurement process received an audit that met professional standards 83 percent of the time (see Figure 2). Therefore, a complete procurement effort is essential. The GAO's report identified four components critical to the procurement process:

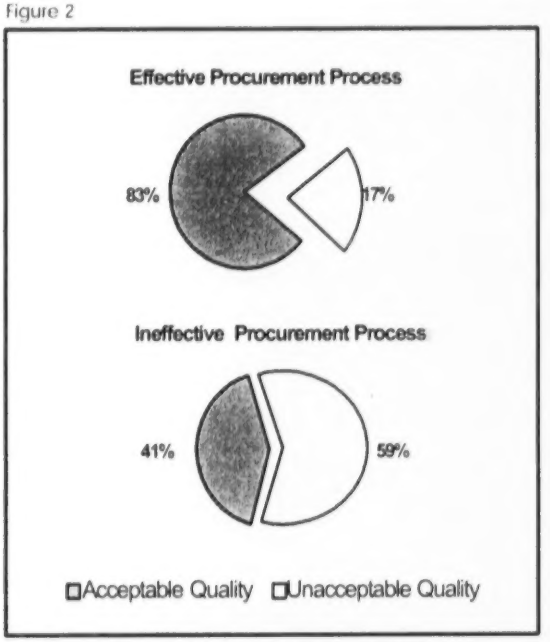
- Competition
- Solicitation
- Technical evaluation
- Written agreement

If these components are effectively included in the college's procurement framework, the likelihood of a quality audit substantially increases.

Why should the college increase competition?

According to *Office of Management and Budget (OMB) Circular A-102*, maximum open and free competition should be a basic principle of all governmental procurements regardless of dollar value or method of procurement. The GAO found that the presence of competition in the procurement process increased the likelihood that the auditors will perform a quality engagement at a fair price. Although price cannot be the primary factor in determining which firm to award audit services, the college increases the likelihood that it will receive an effective audit at a lower price by ensuring that multiple firms are contacted. The GAO found that if the entity attempted to identify at least two CPA firms that could bid on the audit, 79 percent of the resulting audits were of acceptable quality (see Figure 3). Although the GAO found that the presence of competition might not in itself directly affect quality, it suggested that it increased the likelihood of receiving a quality audit and encouraged the auditees to incorporate the other three factors.

Figure 2



Source: *CPA Audit Quality - A Framework for Procuring Audit Services*, United States General Accounting Office, August 1987.

How can the college increase competition?

To increase competition, colleges should identify multiple firms when planning the procurement of their audits. While there is not a "best" method for identifying qualified auditing firms in an area, the most common form is using a bidder's list developed from sources such as the phone book or advertising for proposals in the newspaper. Audit firms outside of the immediate area may also be considered, since firms from other cities may be willing to travel

the phone book or advertising for proposals in the newspaper. Audit firms outside of the immediate area may also be considered, since firms from other cities may be willing to travel to conduct the engagement. Other methods include posting a request for proposal (RFP) at the Texas State Board of Accountancy or direct mailings. The governing boards should ensure that local, state, and federal guidelines are followed in the solicitation process.

By identifying qualified audit firms, colleges can help ensure that at least two audit firms are considered when selecting a qualified auditor. Where feasible, entities should obtain competition in all circumstances, except when exercising renewal options on multi-year contracts.

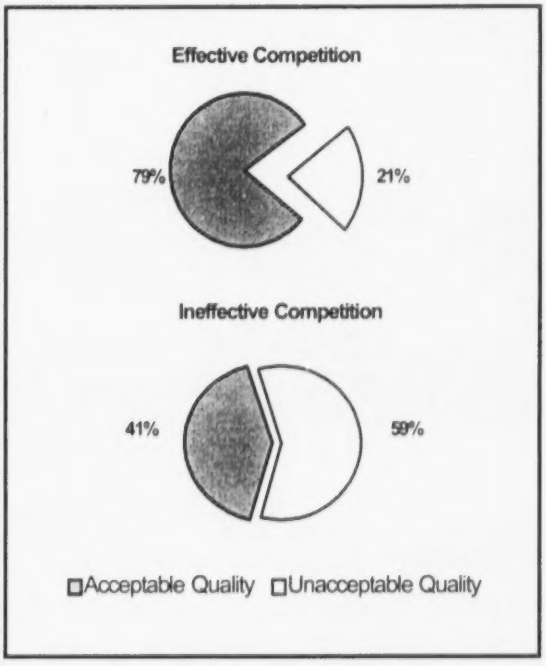
Colleges must make their audits attractive to potential bidders. One way to do this is to provide multi-year contracts when possible, preferably for five years, to the winning audit firm. This will allow them to benefit from the auditors' learning curve and experience and to take advantage of cost savings by not having to procure audit services on an annual basis. However, once the contract does expire, institutions should rebid it to ensure that they receive qualified auditors at a reasonable price.

What is the solicitation process?

The GAO report describes the solicitation process as the steps taken by colleges to communicate its needs and requirements to potential bidders. Once qualified audit firms have been identified, the governing board and institution should prepare an RFP. A well-prepared RFP and the audit firms' proposals will give each side the important information needed to determine if they are compatible.

For example, the RFP should outline the minimum qualifications necessary for the audit and the schedules that must be followed to release the financial statements at the correct time.

Figure 3



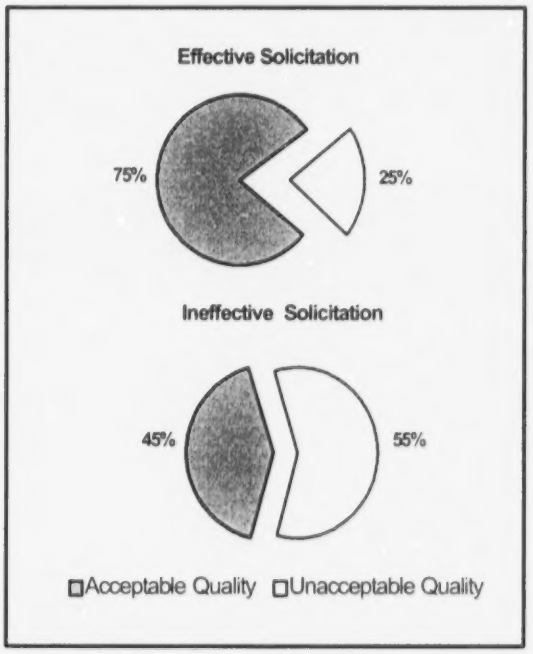
Source: *CPA Audit Quality - A Framework for Procuring Audit Services*, United States General Accounting Office, August 1987.

The proposals should outline the audit firms' qualifications, the staff that would be scheduled to do the project, and other information that will allow the governing board to make an informed decision.

Effective planning is essential to ensure that the college provides the potential bidders with enough information to effectively respond to the solicitation. This in turn allows the potential bidders to determine if they are qualified to bid on the engagement. The firms should also be prompted to submit enough information for the personnel evaluating the bids to select the most qualified auditors at a fair price. According to the GAO, an effective solicitation process included at least four items in its communication with potential bidders. Examples of items meeting this criteria should address background information on the entity, audit period, applicable audit standards, required reports, or

specific audit guides that should be followed. The GAO found that when entities used an effective solicitation process they received acceptable quality audits 75 percent of the time (see Figure 4).

Figure 4



Source: *CPA Audit Quality - A Framework for Procuring Audit Services*, United States General Accounting Office, August 1987.

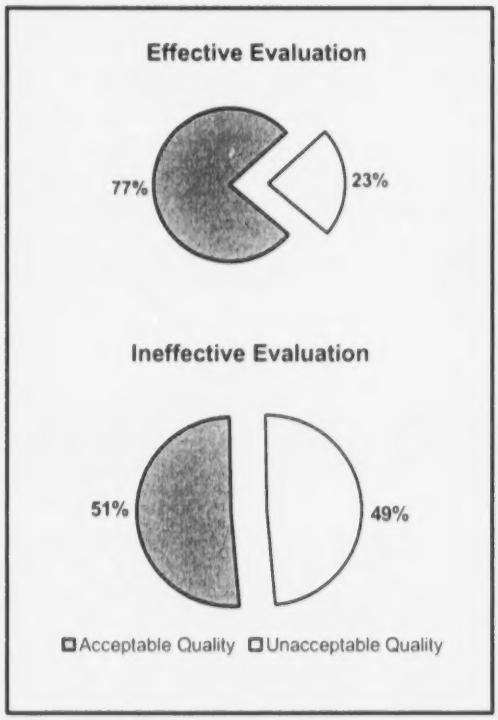
How often should the college go through the solicitation process?

In its report, the GAO suggested that contract periods last for five years. As the contract enters the final year of the contract, colleges should rebid the contract. The question that the colleges must consider is how to balance the cost savings by using the same audit firms with the different perspectives of new auditors, which is necessary to ensure the audit staff rigorously attempt to identify and test risk. Rotation of auditors is essential to get fresh perspectives on the audit. However, colleges should determine if their current audit firms could achieve this influx of new ideas by rotating their own staff. Regardless of what the colleges decide about rebidding, they should consider the benefits of rotation and establish policies regarding its use when appropriate. As a contract enters into the final years, colleges should begin the planning and solicitation process.

How should the college evaluate submitted proposals?

According to the GAO report, colleges must devise a method to evaluate the proposals that are submitted by bidding firms. The colleges should develop evaluation processes prior to soliciting for proposals and may include descriptions of their evaluation methodologies if the firm meets minimum technical qualifications to perform the audit. The evaluation process should also rank the proposals that meet minimum qualifications according to the bidding firms' skills, experience, commitment, and understanding of the audit responses. The GAO decided that in an effective technical evaluation process, the entity considered at least three technical factors, other than cost, in the selection costs. The report found that when an effective evaluation process was used, the entity received an acceptable quality audit 77 percent of the time. However, when an entity did not use an effective method to evaluate technical qualifications, the entity received an unacceptable quality audit 49 percent of the time (see Figure 5). Further guidance on evaluating proposals is presented in step three of the audit cycle (see page C-9).

Figure 5



Source: *CPA Audit Quality - A Framework for Procuring Audit Services*, United States General Accounting Office, August 1987

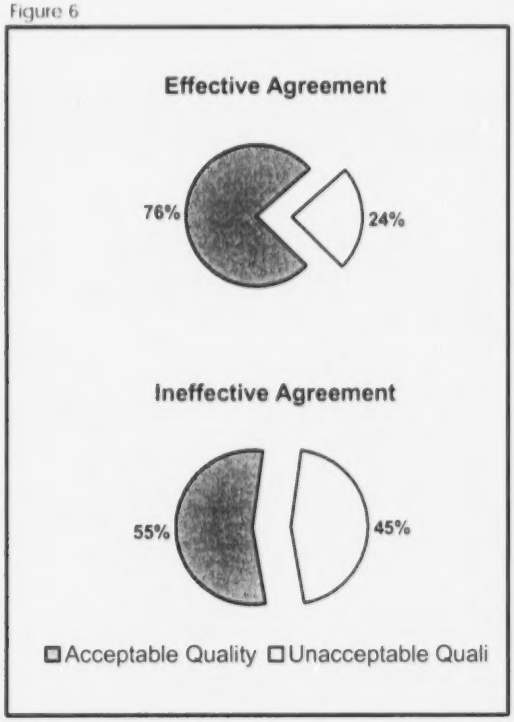
Why is a formal written contract necessary to help ensure audit quality?

The GAO report indicates that written contracts help to ensure a mutual understanding and division of responsibility between the governing board, the college's management, and the audit firm. In its study, the GAO believed that an entity had an effective written contract when the entity had a signed contract or engagement letter that included the following items:

- Statement of the specific audit work to be performed
- Audit scope
- Duration of the audit
- Applicable audit standards
- Required reports
- Applicable audit programs or guides

The written contract should also contain the final terms that the governing board, college, and audit firm agreed on. When an effective written contract was used, the entity received an acceptable quality audit 76 percent of the time (see Figure 6).

Figure 6



Source: *CPA Audit Quality - A Framework for Procuring Audit Services*, United States General Accounting Office, August 1987

For more information about the procurement process, refer to the following sources:

CPA Audit Quality - A Framework for Procuring Audit Services (Report # GAO/AFMD-87-34), United States General Accounting Office, U.S. Government Printing Office, Washington D.C., August 18, 1987.

Gauthier, Stephen J., *Audit Management Handbook*, Government Finance Officers Association of the United States and Canada, Chicago, Il., 1989.

Section C

The Audit Process

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The Audit Process

The Annual Financial Statement Opinion Audit

What is an annual financial statement opinion audit?

In an annual financial statement opinion audit, the auditors or audit organization renders an opinion about the college's financial statements. The auditors must determine if the financial statements fairly and accurately represent the college's financial position and results of operations as of a given date. This opinion helps the general public, board members, donors, and creditors make decisions about the college.

The terms "fairly" and "accurately" are presented within the framework of generally accepted accounting principles (GAAP). Fairness is based on the auditors' judgment as to whether:

- The college's statements are appropriate and in an accepted format.
- The college used appropriate accounting principles.
- The annual financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation.
- The information presented in the annual financial statements is neither too detailed nor too summarized, but is reasonably classified and summarized.
- The annual financial statements reflect the underlying transactions and events in a manner that presents the financial position and results of operations stated within limits that are reasonable and attainable in financial statements.

There are four types of opinions auditors can give when performing an annual financial statement opinion audit:

- Unqualified - The auditors believe that the college's financial statements fairly and accurately represent its financial position and results of operations as of a given date.
- Qualified - The auditors believe that the college's financial statements fairly and accurately represent its financial position and results of operations as of a given date, with one or a few exceptions. Financial statement exceptions include departures from generally accepted accounting principles, inconsistent application of accounting principles, limitations on what the auditors are able to review, or uncertainties affecting the financial statements that can not be satisfactorily resolved.
- Adverse - The auditors believe that the college's financial statements do not fairly and accurately represent its financial position and results of operations as of a given date.
- Disclaimer of Opinion - The auditors cannot express an opinion on the financial statements because something has prevented them from gathering enough information to determine what opinion they should render.

All opinions that are not unqualified require further explanation of the details prohibiting the unqualified opinion. This detail is communicated through the auditors' report.

During an annual financial statement opinion audit, auditors consider materiality. Materiality recognizes that some financial issues (when considered individually or together) are important enough to be considered in evaluating *fair representation of financial statements*, while other issues are not. When auditors render an unqualified opinion, they believe that the financial statements *taken as a whole* are not materially misstated and can therefore be relied

on by interested parties. The knowledge auditors gain through formal training and experience helps ensure that their opinions are appropriate.

Although an institution may receive an unqualified opinion in an annual financial statement opinion audit, there may still be concerns or problems in the institution's management system. For Texas public community colleges, this means that although their financial statements receive an unqualified opinion, internal control weaknesses or inefficiencies may also exist. The colleges may wish to utilize other types of audits (see Figure 7) to identify whether opportunities for improvement do in fact exist.

What are the steps in the financial statement audit process?

There are 10 steps in the annual financial statement opinion audit. These steps are illustrated in the flow chart on Page C-3.

The first four steps relate to the contracting process a community college should generally follow in procuring audit services; steps five through eight comprise the actual audit process, which will result in the external auditors' opinion on the fair presentation of the financial statements; the last two steps detail how the auditors communicate the results of their audit work to the governing board and how these results should be used.

Although the time that auditors actually spend at an institution may only be a few weeks, the steps taken to get the auditors to the campus and then review the results should take much longer. The following sections specifically explain each step in the financial statement audit cycle, highlighting the responsible party.

Figure 7

What An Annual Financial Opinion Audit Does Not Do

An annual financial statement opinion audit focuses on the financial statements of an institution, and is therefore limited in its scope. It is not intended to evaluate management's effectiveness, efficiency, or performance.

Other types of audits are used to assess these issues. These audits include:

- **Operational audits** (also called performance or managerial audits) focus on the institution's internal control system, how well an institution follows its own policies and procedures for recording transactions and maintaining records, and how well the institution is achieving its stated mission and goals.
- **Efficiency audits** focus on the detection and prevention of waste.
- **Compliance audits** focus on adherence to institutional policies and procedures, applicable laws and regulations, and terms of contracts.
- **Investigative audits** focus on the detection of financial abuses, which are usually based on allegations or suspicions of fraud or misappropriation of funds. (Usually, there is no advance notification of an investigative audit.)

Source: State Auditor's Office

PLAN FOR THE PROCUREMENT OF AUDIT SERVICES
The governing board or audit committee should carefully plan to ensure that the audit requirements, auditor selection process, and general timelines meet legal and industry requirements.
PREPARE A REQUEST FOR PROPOSAL (RFP) AND SOLICIT RESPONSES
The governing board with the assistance of the college's management should develop and market an RFP that attracts multiple qualified bidders.
EVALUATE PROPOSALS
The governing board with the assistance of the college's management should review the bids to determine which qualified bidder offers the best value.
CONTRACT FOR THE AUDIT
The governing board with the assistance of the college's management, should prepare a written agreement that documents the understanding and division of responsibility between all involved parties.
PLAN FOR THE AUDIT
The external auditors must plan their audit so that it results in an appropriate opinion in an efficient and effective manner.
CONDUCT FIELDWORK
The external auditors must collect evidence to support their opinion on the financial statements.
MONITOR THE AUDIT'S PROGRESS
The governing board should monitor the progress of the external auditors to ensure that the terms in the written contract are met.
EVALUATE THE QUALITY OF THE AUDIT
The external auditors should evaluate their work to ensure that it complies with industry standards.
COMMUNICATE AUDIT RESULTS
The external auditors with the assistance of the audit committee, should communicate the audit results to the governing board and college management through formal audit reports.
RESOLVE THE AUDIT
The governing board should decide which audit recommendations to implement and then monitor the college's efforts to implement them. The governing board should also evaluate the external auditors performance to determine if their contract should be renewed.
THE AUDIT CYCLE
The audit process is a cyclical process. Experiences from previous audits feed into the next cycle's planning and procurement phases. Although the time that auditors actually spend on your campus may be only a few weeks, the steps taken to get the auditors to the campus and then to review the audit's results should take much longer.
As directed by the General Appropriations Act, 75th Legislature, the Financial Statement Opinion Audit Guide for Texas Public Community Colleges requires local boards to ensure that their independent auditors contact both the SAO and the Texas Higher Education Coordinating Board's Community and Technical Colleges Division during the audit planning process. The board should take this into account during its planning, solicitation, evaluation, and contracting steps.

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Contracting for Audit Services

Contracting for annual financial statement audits is a cyclical process. Experiences from previous audits feed into the next cycle's planning and procurement phases.

Step 1:
Plan for the procurement of audit services

Because governmental auditing differs from audits of public companies in many respects, governing boards must ensure that their procurement processes result in contracts with independent auditors who comply with federal, state, and local requirements. Careful planning will ensure that the auditors' services match the colleges' needs. Those people responsible for procuring audit services should consider the following steps, as outlined in the Government Finance Officers Association's (GFOA) *Audit Management Handbook*:

- Research state and local requirements to determine if they are applicable. The State requires that community colleges submit audited financial statements annually. Local requirements may include financial or performance audits. The governing boards and management should determine which audit requirements apply. They should also determine if they could benefit from additional audits that are not necessarily required.

- Determine legal and regulatory requirements applicable to the audit procurement process. Federal, state, and local laws often regulate the procurement of audit services. The governing board and management should determine whether the federal, state, or local governments legally mandate how the institution can solicit proposals and contract for audit services.

- Determine whether the college is subject to the provisions of the Single Audit Act. The United States Office of Management and Budget and the Single Audit Act establish detailed audit requirements for institutions receiving federal funds. Recipients of federal assistance are required to undergo an audit of those federal funds when expenditures from federal funds total $300,000 in any fiscal year.

- Define the institution to be audited. The governing boards and management should determine what institutions are included in the reporting institution to be audited. The reporting institution may contain legally separate institutions in the college's financial statements if they are a component unit of the college. The governing boards and management should consider multiple criteria when determining whether component units of the college exist. Refer to Statement No. 14 of the Governmental Accounting Standards Board – *Financial Reporting Institution* for guidance.

- Determine if the auditor will be required to report on financial statements prepared on a non-GAAP basis of accounting. The college may have to submit additional financial statements prepared on a basis of accounting other than GAAP to comply with legal requirements. The governing boards and management should determine whether non-GAAP statements and schedules need to be included in the scope of the audit.

- Determine audit coverage for each level of information at the college. The basic accounting unit for community colleges is the "fund." Information from funds can be presented on an individual fund level, combining fund level, or combined fund level. The combined fund level is prescribed by the Texas Higher Education Coordinating Board's annual financial

- reporting requirements. This level combines all funds within a particular fund type into a single column with a combined total column for all fund types. Colleges should determine whether the external and internal users would benefit from including combining or individual fund level statements in their audited financial statements.

- If more than one audit firm is to be engaged or relied upon, define the relative audit scope of each. There is not a requirement that a single audit firm perform an entire audit of a college's financial statements. Although the common practice in community colleges is to retain a single auditor or firm, the governing boards could elect to hire multiple auditors to perform different parts of the audit. If multiple auditors are hired, the governing board should designate one of the auditors as the principal auditor or firm. The principal audit firm is the only firm that can express an opinion on the financial statements for the institution as a whole. The board should take care to minimize overlapping coverage.

- Determine the relevant auditing standards to be used in the engagement. All financial statement opinion audits must be performed in accordance with GAAS, which are established by the AICPA. Additionally, audits of governmental institutions must be conducted according to GAGAS. These standards establish additional requirements to meet the special demands of the public sector.

- Determine how the institution can assist the auditors. Community colleges can limit audit costs by assisting the auditors. If a college plans to do this, it must provide the promised assistance in a timely manner and ensure that someone at the college has clear responsibility for coordinating the assistance. Colleges can provide:

- Internal audit support
- Clerical support
- Electronic data processing
- Use of specialists
- Collection of documentation prior to the audit
- Preparation of the financial statements
- Access to workspace
- Communication equipment
- Use of audit contacts to help the external auditors address inquiries.

- Establish timelines for auditor reporting and preparation of the financial statements. The Texas Higher Education Coordinating Board requires the colleges submit audited financial statements by January 1st every year. In addition, there may be federal or local deadlines. To ensure that all deadlines are met, the officials planning the audit must establish an ongoing timetable so that delays are identified and corrected quickly. Some institutions require periodic status reports from their external auditors so that the financial statements can be issued in a timely manner. The governing board should also establish a schedule for the college's own preparation of the financial report.

- Establish the procedures for selecting the external auditor. The process used to select the external auditors should be both systematic and well documented. It should ensure that the audit meets legal requirements and that the auditors' qualifications meet quality standards. Essentially, at least three factors should be considered when selecting external auditors: their qualifications, the audit approach to be followed, and the price. At no time should a college select an auditor based on price alone. Price should be used to select between equally qualified audit firms providing similar services. The selection process should place the most weight on an auditors' qualifications, while ensuring that legal requirements are met.

Step 2: Prepare the Request for Proposal (RFP) and solicit responses

A governing board should consider the following steps as outlined in the GFOA's *Audit Management Handbook*.

- Describe how the proposals will be evaluated. If the RFP clearly indicates that quality and price will be considered in selecting the audit firm, high-quality firms may be more inclined to submit proposals. A college may go as far as explaining the risk ranking methodology used to evaluate proposals, the personnel that will evaluate the proposals, and the minimum qualifications that will be considered. By outlining minimum qualifications, the governing board is more likely to receive proposals from competent firms.

- Provide information on how an audit firm should make its proposal. The RFP should indicate how the proposal should be formatted. If the same format is required of all proposals then it will be easier to compare proposals from different audit firms. Also, the RFP should indicate whether the governing board will hold a pre-proposal conference to answer questions from potential bidders. This can keep the governing board from answering the same question repeatedly. Finally, the RFP should clearly outline time frames for submission and evaluation of proposals.

- Describe the community college and its accounting structure. Potential bidders need to know whether they have the expertise and resources necessary to complete the audit within required time frames. Helpful information includes:

  - The institution's organizational structure
  - The institution's fund structure and basis of accounting
  - Whether the audit needs to include federal and state financial assistance
  - If the institution maintains a pension plan
  - Whether component units and joint ventures exist
  - The complexity of the institution's electronic data processing activities
  - If the institution maintains an internal audit function
  - If prior year reports exist and where they can be located

- Describe known weaknesses in the institution's internal control structure. The RFP should contain a complete list of all audit findings from the previous year's audit report, even if findings are resolved prior to the release of the RFP. This helps the audit firm evaluate the complexity of the audit.

- Describe potential problems that may arise from new accounting standards or legal requirements. New accounting standards are often difficult and costly to implement. Potential bidders need to be aware of developments that could significantly impact the scope of their work.

Describe the auditors' principal contacts inside and outside the college. It would be helpful for potential bidders to know who they are expected to work with during the engagement. Examples of contacts include the chief financial officer of the college, members of the audit committee, the director of internal audit, legal counsel for the college, the Texas Higher Education Coordinating Board, and the State Auditor's Office. In addition, there may be contacts stemming from federal or local laws. The RFP should also require the external auditors to contact both the State Auditor's Office and the Texas Higher Education Coordinating Board during the audit planning phase of the engagement.

- Define the level of responsibility that the external auditors will have for each part of the financial statements. The auditors may assume different levels of responsibility in rendering an opinion on the financial statements. If the college decides not to obtain a full-scope audit (one which provides assurances on both the general financial statements and the individual fund level statements), the RFP should indicate responsibility for the individual fund statements and schedules. Standards from the Governmental Auditing Standards Board (GASB) encourage the external auditors to address the individual statements and schedules in their report on the general financial statements.

- Describe the auditing standards required for the engagement. The RFP should state that the audit is to be conducted in accordance with GAAS, as well as GAGAS. If the college must receive a single audit for federal funds, the external auditors must follow standards established by the United States Office of Management and Budget. Any state or local requirements should also be disclosed. This information allows the potential bidders to determine if they are qualified to perform the audit.

- Describe the auditors' specific reporting requirements. Although auditing standards dictate most of the auditors' reporting duties, the RFP should reiterate the required reports to lessen the chance of misunderstanding. The auditors have reporting requirements in the following areas:

  - Auditors' report
  - Reportable conditions
  - Nonreportable conditions
  - Nonmaterial instances of noncompliance irregularities
  - Illegal acts and indication of illegal acts
  - Other matters to be brought to the attention of the board.

- Describe the required audit timetable and audit deliverables. The RFP should include the deadlines established during the audit planning, including the latest acceptable dates for the entrance conference, the completion of interim and year-end fieldwork, the submission of audit adjustments and draft findings, the exit conference, and the issuance of the audit report. This information will allow the potential bidders to determine if they have sufficient resources to complete the audit on time.

- Describe additional services required of the auditor. If the college desires any non-audit services, such as assistance in drafting the financial statements or issuing comfort letters, they should be clearly described in the RFP. This will help prevent miscommunication, especially when the college switches auditors. Requesting additional services may hinder competition as qualified firms may be unwilling to provide them.

- Describe any assistance that will be available to the auditors. The RFP should indicate if the college plans to provide assistance to the external auditors, as well as furnish workspace and office equipment to the audit staff. By furnishing clerical support, internal audit support, or other types of assistance, the college may lower its audit costs. If the college wishes to place restrictions on the audit staff, such as using computer equipment at low demand times or requiring the auditors to meter photocopying, these requirements should be disclosed in the RFP. The RFP should also state when schedules prepared by the college will be provided to the auditors.

- Describe the procedures necessary to determine if additional audit work is needed and the fee basis for such work. The final price bid establishes the maximum amount that the college will pay for the audit work described in the RFP. Sometimes, the scope of an audit must be expanded based on

weaknesses uncovered in the audit. It is essential that the RFP dictate that the audit scope can only be expanded with express written consent of the college. The RFP should also require that the audit firm provide a revised fee proposal for the additional fieldwork.

- Describe specific information needed to evaluate the proposals. The RFP should request the following information from bidding audit firms to determine if they satisfy quality thresholds:
  - Description of the audit firm
  - Qualification of audit staff assigned to the engagement
  - Circumstances whereby audit staff can be changed
  - Ability of the governing board to approve or reject replacements
  - Additional relevant information about their qualifications.
- Require a statement from the auditors that they meet the appropriate criteria for independence. The RFP should require the auditors to provide formal statements indicating that they are independent of the college and any material component units, in fact and appearance, according to standards established by GAAS or GAGAS as appropriate.
- Request references from other governmental clients. The RFP should ask bidding firms to supply the names of other institutions where they have recently performed similar audits, if the college intends to use references as part of the evaluation process. The proposal should also give a contact name at each institution so that the college can verify the quality of the audit work performed. If the college does not use references as part of the evaluation process, the RFP should not require that references be provided.
- Request information on prior peer reviews. GAGAS require firms that audit governmental units to undergo external peer reviews every three years. The RFP should require that bidders supply the results of their latest peer reviews and indicate whether these peer reviews examined fieldwork performed on governmental audits. In addition, the RFP should require the auditors to provide the results of any desk reviews or field reviews performed by federal, state, or local agencies.
- Request status of any disciplinary action taken against the firm. The State Board of Public Accountancy regulates the CPA profession in Texas. Additionally, the American Institute of CPAs also has the ability to take action against audit firms or individuals that engage in unethical practices or perform substandard work. The RFP should require bidders to disclose any disciplinary action taken against the firm from any level. This disclosure should include the status of the action and relevant details of the circumstances. If the bidder fails to respond or provides incomplete information, the college should contact the State Board of Public Accountancy to determine if any disciplinary action has been taken against the firm.
- Request detailed information on the anticipated audit plan. The RFP should request a detailed description of the bidder's planned audit approach. This will help the governing board evaluate whether the audit firm has a good understanding of the audit's scope and the college's environment. The RFP should ask to what degree the firm relies on audit sampling and analytical testing, what types of analytical testing the firm would use, and how the staff members will be split among the various segments of the audit.

- State working paper requirements and cooperation with other auditors. Working papers compose the main record of the auditors' work and support their conclusions. Therefore, they are necessary for quality reviews and developing an understanding of the auditors' judgment. Although the working papers remain the property of the auditor, the RFP should describe the period that the working papers should be retained and the individuals that can access them. The RFP should also state the auditors' responsibility to cooperate with successor auditors.

- State the policy the college has toward joint proposals or subcontracting. Unless the RFP specifically prohibits joint proposals or subcontracting, it should contain provisions retaining the college's right to accept or reject subcontracting firms. If joint proposals or subcontracting is allowed, the RFP should require the audit firms to designate a principal auditor.

- Specify the college's right to reject proposals, demand additional information, and use information from unsuccessful proposals for other purposes. The RFP should ensure that the college is not legally forced to select an unqualified or unresponsive firm by stating that:

  - The college has the right to refuse any or all proposals.

  - The college has the right to request additional information from bidders and that failure to comply may be grounds for rejection.

  - The college reserves the right to retain proposals and use any information contained within it and that the college is not obligated to reimburse firms for costs incurred responding to the RFP.

- Provide additional language needed to meet the requirements of applicable laws and regulations. Procurement of professional services is generally subject to local, state, and federal laws. Sometimes these provisions require certain language in the RFP. The governing board should consult with its general counsel to determine if all legally required language has been included in the RFP.

Step 3: Evaluate proposals

If the RFP was written effectively, the proposals should contain the information necessary for the college to determine the candidate that offers the best value. It is important to remember that price should never be the solitary factor in awarding a contract. The GAO's report indicated that a college was less likely to receive a quality audit if price was the only criterion used. It is important for a college to include people knowledgeable about governmental accounting and auditing in the planning process, and it is imperative that these people be involved in the evaluation process. While a well-written RFP will ensure that important information necessary for evaluation is submitted, the process is likely to fail without a sound system to judge which bid should be selected. The GFOA's *Audit Management Handbook* suggests the college follow the following steps when evaluating proposals:

- Review mandatory criteria. The proposal should contain the minimum requirements as stated in the RFP. Any proposals that fail to meet these standards should be rejected. Mandatory criteria should include:

  - Meeting of independence standards

  - Licensure by the State Board of Public Accountancy

  - Evidence that audit firm personnel have sufficient and relevant continuing professional education

  - Evidence that the proposing firm has had a satisfactory quality control review

in the past three years

- Evidence that the audit firm is capable of performing the audit

Mandatory criteria should be limited to only the skills necessary to perform the audit. Once unqualified proposals are rejected, the college can concentrate on evaluating the relative qualifications of bidders that do qualify.

- Establish a rating method for technical qualifications. The evaluators should develop a methodology to rank the remaining firms on their technical skills. Some institutions establish a point system that assigns a number of points for expertise and experience, audit approach, and price. There is no one methodology that will work for every college. Every college must tailor its methodology to address its unique operating environment. Evaluators should develop a sliding scale when evaluating the proposals, rather than an "all-or-nothing" score. This helps firms that are highly qualified rank higher than those firms that are only marginally qualified. For example, Firms A and B may be proficient in automated data systems, but Firm A may be familiar with the system used by the college. Since this makes Firm A more skilled in the college's unique environment, it should receive more points than Firm B.

- Ensure that the evaluators are unaware of price until technical qualifications are evaluated. In the evaluation process, it is important that the evaluators are not influenced by the price. Therefore, the evaluators should not see the price bid until they determine the bidders' technical qualifications. One way to do this is to follow a multi-step process. In the first step, the bidders submit their technical qualifications. Firms that satisfy the mandatory technical qualifications would then be asked to submit information about their planned audit approach. Finally, firms that fulfilled both requirements would be asked to propose their bids for audit services. Whatever method is employed, the college should ensure that the evaluators do not see prices until their technical review has been completed.

- Ensure that price is accorded a proper role in the auditor selection process. Although price cannot be the determining factor in auditor selection, it is an important factor. If the point system established in step two splits total points between technical qualifications, audit scope, and price, the points allocated to price should represent the appropriate weight compared to the other factors. Price should not control the selection of the auditor; rather it should be used as a way to select among equally qualified bidders. The college should determine how many points will be awarded based on price and how the bids will be scaled. One method is to develop a ratio comparing the lowest bid from a qualified firm to the bid being reviewed. This would indicate how many points the firm would receive based upon its price bid. The college should also consider invoking an unpublished price floor or ceiling to help reject bids that are unreasonably low or high.

- Consider legal provisions from state, federal, and local sources. Federal, state, or local requirements may regulate the college's procurement process. For example, state regulations prohibit the selection of an auditor based solely on price. There may also be state or local laws that dictate how the college should procure professional services. The college should consider these requirements when evaluating proposals.

By following the steps outlined above, the college is more likely to secure a qualified audit firm who can perform a quality audit.

Step 4: Contract for the audit

Once the college has identified the proposal offering the best value, the college needs to write a contract to ensure that the audit meets quality standards. The written agreement is the last step in the audit procurement process. The GAO report indicates that the written agreement is one of the four necessary components in a successful procurement process.

Although many colleges rely on the engagement letter to serve as the contract, a properly prepared audit contract is essential in procuring audit services. The final contract needs to contain specific language documenting the understanding between the auditors and college.

Most of the information mentioned below will already be contained within the RFP, so the college should consider referencing it in the final contract. The provisions listed below are illustrative only. The college must determine what items need to be included in the contract. Legal counsel should always be consulted to help draft the final contract.

The college should consider having the written contract include the following provisions:

- Designate the responsibilities of the independent auditors and the college.
- Require the audit firm to formally assert that the staff members assigned to the audit are independent.
- Outline the circumstances under which the auditors can expand the scope of the audit.
- Require the auditors' services to defend the college in the defense of claims arising from the auditors' work.
- State the college's commitment to equal economic opportunity (Historically Underutilized Businesses) and require the auditors to afford such individuals similar consideration.
- Clarify policies regarding the working papers arising from the audit. The college should state who may access the working papers and the length of time that the audit firm must retain them.
- Ensure that any reports provided to the college by the auditors become the property of the college. The college should also clarify the auditors' duty to confidentiality of sensitive information.
- Give the college the right to terminate a multi-year contract and establish the procedures used to do so. Additionally, the contract should describe how the firm's performance will be evaluated.
- Establish the auditors' sole liability for claims arising from the auditors' performance of the engagement. The contract can also call for both the auditors and the college to attempt to resolve differences agreeably.
- Document what constitutes legal notice (such as registered mail). Specify how terms of the contract can be modified or waived. Additionally, the contract may include language indicating that the provisions of the contract stand alone. Thus, if one party fails to satisfy a single provision, the entire contract is not nullified.
- Include any other legal provisions needed in the written agreement (for example, if the auditors must secure insurance or if the college prohibits subcontracting out portions of the audit).

The steps outlined above complete the contracting portion of the audit. Until now, the audit cycle has mainly focused on the college and its governing board. While their job is not complete, the focus now shifts to the external audit firm.

The Auditing Procedure

Step 5:
Plan for the audit

Once a firm is awarded the contract, it must begin planning for the audit to comply with auditing standards. Although the firm had to do preliminary planning in developing its RFP, it is unlikely the firm committed a great deal of resources until it was awarded the contract. Once this happens, it will begin by determining what the objectives of the audit are. This should already have been described during the RFP process, but the firm will need to decide what it needs to do to render an opinion on the financial statements.

An audit must be performed effectively and efficiently. Therefore, the audit firm must determine where and when to commit its resources. If the RFP process was sound, the audit firm will have already been alerted to and accepted deadlines for its work.

The General Appropriations Act, 75th Legislature, states that local boards must require their independent auditors to contact both the SAO and the Texas Higher Education Coordinating Board's Community and Technical Colleges Division during the audit planning process.

According to the AICPA's guide *Audits of State and Local Governmental Units*, the auditors should follow these steps during the planning phase:

- Identify the engagement's reporting objectives. The reports required by the college should have been identified in the RFP and incorporated into the final contract.

- Identify the auditor's role as principal, component unit, or joint auditor. This information should be contained in the final written contract, as well as in the firm's proposal.

- Develop the audit focus and materiality thresholds based on the reporting format established by the Texas Higher Education Coordinating Board (THECB). Because THECB's reporting guidelines require the colleges to present combined financial statements, the auditors should alter their scope and materiality thresholds to address the funds and accounts presented in the financial statements. A materiality threshold is the amount that the financial statements can be over or under-stated and still not be misleading to a competent reader.

- Develop an understanding of the college. The auditors should research background information about the college on which to appropriately base subsequent audit planning. The external auditors may be able to rely on the work of the college's internal audit staff. The more the auditors know about the college's operations and environment, the more effective their work will be.

- Consider the effectiveness of internal controls. Internal controls help ensure that material errors in accounting transactions are either prevented or quickly discovered and corrected by the college. Therefore, the auditors must develop an understanding of these controls so that they can determine whether they are effective. If internal controls are effective, the auditors can limit the amount of testing necessary to render an opinion.

- Consider the likelihood that misrepresentations exist in the financial statements. Some factors enhance the risk that material errors, irregularities, or illegal acts caused financial statements to be materially misstated. The auditors should determine if such factors exist and whether their testing should be expanded to compensate.

- Develop the audit approach. The RFP may have requested the bidding firms to provide a proposed audit approach. Therefore, the audit firm may have already prepared a preliminary audit approach. However, as the auditors learn more about the college and its environment, they will revise their preliminary plans. The approach should provide assurance that audit fieldwork is directed to secure the evidence necessary to support the auditors' opinion while helping to prevent unnecessary work.

- Conduct pre-audit communication with the college. Responsibilities of each party should have been established through the written contract. However, the auditors should consider conducting an entrance conference to provide more detailed information than is contained in the contract. At the entrance conference, the audit firm will generally introduce its team and explain the audit objectives, purpose, and limitations. This information may also be included in the engagement letter.

- Determine whether an additional audit will be required. The auditors should be aware of requirements for additional audits based on local, state, or federal laws. Although these should be described in the written contract, the auditors should ensure that legal provisions are appropriately satisfied.

- Determine compliance requirements. The auditors should obtain an understanding of the possible effect on the financial statement of laws and regulations that have a direct and material effect on determinating the amounts reported in the financial statements. The auditors should also assess whether the college has done the same.

- Perform analytical procedures. Analytical procedures are tests of significant ratios, fluctuations, and trends. The auditors are required to conduct analytical procedures during the planning phase of the audit to gain an understanding of the effects of significant events or actions taken by the college. The auditors should remember that overall analytical procedures are less effective when applied to combined financial statements. Therefore, the auditor should perform tests at a level sufficient to gain this understanding.

- Develop an audit program. Although the audit firm supplied an initial audit approach during the proposal phase, standards require a formal written program or set of programs. The auditors must develop the programs to provide sufficient evidence to support their opinion on the financial statements.

Step 6: Conduct fieldwork

After the audit firm plans the engagement, it must conduct fieldwork to collect the evidence it needs. This may be the first time that the auditors actually come to the college.

This section of the audit is comprised of eight steps that vary in importance from audit to audit:

- Gain an understanding of the college's systems. Much of this step's preliminary work may have been done in the planning phase as the audit programs were developed. The audit firm relies on multiple sources to gain an understanding of the control systems that the college uses. These sources can include policies and procedures manuals, the previous audit firm's working papers and interviews with the college's personnel.

- Record the understanding. The auditors should record the information that they receive so that they can assure themselves that their understanding is correct. The auditors often document their understanding in a general sense, with underlying detail to support their conclusions.

- Evaluate internal controls. Once they conclude how the systems are designed to

work, the auditors must determine if they can rely on the underlying internal controls of a college. To make the audit efficient, the auditors cannot look at every control the college has in place. Therefore, the auditors must choose which controls to look at. They will do this by ascertaining which controls provide reasonable assurance that the affected accounts are accurate. Apparent control weaknesses may also be discovered during this phase. Control weaknesses should be communicated to the college and governing board as specified in the written agreement.

- Confirm that controls are in place and working. Once they determine which controls to look at, the auditors will begin testing the controls to assess if they are effective. Based on the results of their tests, the auditors can adjust the remainder of their audit work based on actual first-hand knowledge of the control structure. Additionally, the auditors may discover areas for improvement based on their tests. These suggestions should be forwarded to the board or management.

- Make the final evaluation of internal control. The tests of controls above will support or contradict the auditors' understanding of the internal control structure. If the auditors find that controls are in place and working, they can place more faith in the amounts as presented in the financial statements. Conversely, if controls appear to be missing or not functioning, the auditors must gain more persuasive evidence to support their opinion. Weaknesses that the auditors discover are generally confirmed in a formal letter to the college's board or management. This letter, known as the management letter, is one of the most beneficial services provided by the auditing firm.

- Complete the audit. After the auditors have assessed the internal control structure and performed tests to determine if the controls exist and are effective, the auditors move to the final phases of the audit. The auditors' final evaluation of internal control determines the extent of subsequent tests. If the internal control structure appears to be operational and effective, the auditors may be able to perform limited tests to determine if the financial statements are materially accurate. However, if the internal control structure is weak or ineffective, the auditors will be forced to expand their testing to issue an unqualified opinion on the financial statements. During this phase of the audit, the auditors not only assess whether account balances are accurate, they also attempt to determine if management's decisions regarding the financial statements are accurate. For example, the auditors will test if management's valuation of assets was based on sound accounting principles, as well as the actual valuation of the account.

- Review the financial statements. The financial statements are the responsibility of both the college's governing board and management. However, they are often the result of an ongoing consultation between the auditors and the college. The auditors provide expert advice on a variety of matters, such as form, application of accounting principles, and suggestions for wording. The extent of participation varies greatly from engagement to engagement.

  Some colleges prepare their own financial statements, which the auditors review and propose form or content adjustments. Other colleges have the auditors prepare the draft financial statements, which they review. One thing is important to remember: the financial statements are the responsibility of the governing board and reflect their decisions. The auditor who drafts the financial statements must remember that the financial statements are the college's representations, not their own. Therefore, auditors who draft statements should ensure they do not reflect the auditors' decisions regarding accounting treatments, presentation, or any other decisions normally reserved for the board.

- Issue the opinion. The opinion letter is one of the most recognizable deliverables from an engagement. The letter indicates whether or not the financial statements fairly present the account balances and results of operations of the college for a certain point in or period of time. The opinion is not an indication that management operated as intended or that the internal control structure is effective. A college could receive an unqualified opinion, even though it did not have effective controls. The auditors must base their opinion on the evidence they collected during the engagement. The audit firm must ensure that looming deadlines do not force them into prematurely issuing an opinion that cannot be logically supported.

Step 7: Monitor the audit

Even if a college uses sound procurement processes and selects a qualified audit firm, there is no guarantee it will receive a quality audit. However, the chances are increased if the college monitors the audit once the audit firm has been selected. According to the GFOA's *Audit Management Handbook*, an audit committee or governing board must stay current regarding the progression of audit work to help ensure the audit is appropriately conducted.

A well-written contract will have clearly defined timetables for both the audit firm and the college and will allow for periodic status meetings, to ensure that the audit committee is well aware of how the audit is progressing. When the audit committee learns of timing problems it should immediately take steps to ensure that the audit can be satisfactorily completed within the required timeframes. If the audit firm has encountered problems with the college's management or personnel these should also be communicated to the audit committee or governing board.

Step 8: Evaluate the quality of the audit

If auditors follow GAGAS they will provide a quality audit. To ensure that standards are followed, the audit firm should have a sound quality review process in place. The audit firm must reexamine the working papers from the audit to ensure that they are complete, logical, and contain competent and sufficient evidence to support the conclusions made by the firm.

Someone other than the preparer of the working papers should conduct the review. The quality control reviewer should have sufficient technical skills to determine if the conclusions are appropriate. Therefore, it is important that an experienced auditor, who can bring all of the pieces of the audit together, from the planning through the fieldwork, carefully review the auditors' work. The experienced auditor should be able to develop the same conclusions that the audit team did based on the work and evidence documented in the working papers.

The quality control review also provides assurance that the audit was conducted in accordance with GAGAS and that weaknesses and other material findings have been communicated to the appropriate level of management at the college.

The quality control review process should be conducted throughout the audit. This process should allow an objective confirmation of the audit firm's findings from staffing the audit to issuing the opinion. If there is not a competent and objective review of the working papers, the audit will fail to comply with GAGAS, increasing the likelihood of an unacceptable quality audit.

Reporting and Resolution

Step 9:
Communicate the audit findings

Auditing standards require that the auditors communicate the results of their audit work to the college. Many of the reports that are optional under GAAS are required by GAGAS. The number and scope of reports will vary according to the engagement and written contract. Some of the more common reports include the following:

- Report on the financial statements. In all financial statement opinion engagements, the auditors will prepare a report on the fairness of the presentation of the financial statements. This report indicates whether the financial statements are materially accurate. This report will contain one of the four different types of opinions: unqualified, qualified, adverse, or disclaimed (See page C-1).

- Report on the internal control structure. GAGAS require that auditors issue a report on their study of the internal control structure. Although the amount of work that the auditors do is generally not enough to render an opinion, the auditors' report often lists any reportable conditions, as well as material weaknesses found.

- Report on compliance with applicable laws and regulations. GAGAS require that auditors issue a report on the results of compliance testing they did in this course of the audit. The report must indicate that all transactions tested, unless otherwise noted, complied with applicable laws and regulations.

- Report on the Schedule of Federal Financial Assistance (Schedule). Colleges expending $300,000 or more in federal funds in a single year are required to have an audit of those federal funds. While the Schedule itself does not have to be audited, the audit firm must provide a statement that the information in the Schedule has been subjected to the auditing standards applied during the review of the institution's financial statements.

- Report on internal controls used in administering federal financial assistance programs. Auditors performing single audits are required to report on both financial and administrative controls over federal funds used by a college.

- Report on compliance for federal financial assistance. The Single Audit Act requires auditors to report on compliance for federal financial assistance programs. In this report, the auditors must report all known instances of material noncompliance, render an opinion on whether the college has complied with the requirements for each federal financial assistance program tested as a major program, and report on compliance with general requirements applicable to major federal programs.

- Letters to management. In private practice, management letters are used to communicate reportable conditions and material instances of noncompliance. Since GAGAS require that these instances be reported in a separate report, the management letter is primarily used to communicate nonreportable conditions and immaterial instances of noncompliance.

- Reports on Illegal Acts. GAGAS require the auditors to inform the college not only of irregularities and illegal acts, but also indications of potential illegal acts.

The audit committee should review all reports that are furnished to it by the auditors to gain a thorough understanding of the underlying

conditions. The audit committee should use this understanding to determine how to proceed in resolving any problems.

Step 10:
Resolve the audit

As the governing board receives information during the audit, it is responsible for taking appropriate action. Before the audit report is published, the board should coordinate with both the college's management and the external auditors to correct any deficiencies encountered during the audit. This review should include the following:

- The nature of any unresolved accounting and auditing problems
- The nature of any significant adjustments, reclassifications, or other disclosures suggested by the auditors
- Any material errors, irregularities, or possible illegal actions
- The sufficiency of financial statement disclosures and compliance with applicable laws and regulations
- Changes in accounting principles or policies during the year
- Any disagreements with management that, if unresolved, would have resulted in a modified opinion on the financial statements
- Reasons for major year-to-year fluctuations in financial statement balances
- Unusual situations or circumstances reflected in the financial statements
- The nature of management's underlying assumptions
- Any significant changes in the format of the financial statements from previous years
- Any material weaknesses in internal controls
- Recommendations in the auditors' management letter for improving internal controls and the status on previous recommendations

When the board receives the auditors' recommendations and report on the status of previous recommendations, the board should ensure it has a thorough understanding of what the auditors are recommending. The board should then determine whether the auditors' recommendations are appropriate for the college.

If the board decides that the auditors' recommendations should be implemented, it should require that the college's management develop an implementation plan with a timetable. If the board decides not to implement the auditors' recommendations, the board should document its reasons. The board should review the college's progress on implementing the recommendations until they are complete. Throughout the audit, the audit committee or board should monitor the external auditors to ensure that the engagement progressed as planned.

Once the audit is complete, the committee should determine if anything in the audit process needs to be changed before the next audit starts. This review concentrates more on the auditors rather than the audit itself. According to the GFOA's *Audit Management Handbook*, the committee should meet with the college's management, without the audit firm present, to discuss the quality of the auditors' work. This meeting should focus on the following items:

- How well the audit staff met the timeframes established in the contract
- How well the audit staff complied with the other provisions of the contract

- The competence and cooperativeness of the audit staff
- The thoroughness and reasonableness of audit adjustments, findings, and recommendations

The results of this discussion should allow the audit committee to present a recommendation to the full board about whether to retain the audit firm for the next year or whether the firm should not be considered during the next phase. If the committee finds that the audit firm did not provide a quality audit, it should recommend to the members of the governing board that they exercise the exit clause in their written contract to terminate the auditors' services. The audit committee should also meet with the audit firm, without management present, to determine if the auditors found management, at all levels, to be competent and efficient.

Section D

Appendix

Additional Resources

Early in the process of developing this guide, it became apparent that very detailed literature existed which described most of the processes listed above. Rather than duplicate the efforts of these publications, the SAO decided to summarize these other sources, so that this guide could be used as a primary resource, with directions to more extensive guidance when necessary. Please consult the listed resources:

Responsibilities in the Audit Process

Apostolou, Barbara, Ph.D., CPA, and Raymond Jeffords. Ph.D., CPA, *Working with the Audit Committee*, The Institute of Internal Auditors, Alamonte Springs, FL., 1990.

KPMG Peat Marwick, Audit *Committees for State and Local Government*, Peat Marwick Main & Co., U.S.A. 1988.

Procurement Processes

CPA Audit Quality. A Framework for Procuring Audit Services (Report # GAO/AFMD-87-34), United States General Accounting Office, U.S. Government Printing Office, Washington, D.C., August 18, 1987.

Gauthier, Stephen J., *Audit Management Handbook*, Government Finance Officers Association of the United States and Canada, Chicago, Ill., 1989.

Guidance on Auditing Standards

Audits of Colleges and Universities, American Institute of Certified Public Accountants, New York New York, 1998.

Audits of State and Local Governmental Units, American Institute of Certified Public Accountants, New York, NY, May 1995.

Government Auditing Standards, United States General Accounting Office, U.S. Government Printing Office, Washington D.C., June 1994.

Codification of Statements on Auditing Standards, American Institute of Certified Public Accountants, New York, NY, 1998.*

General Accounting and Reporting Guidance

Annual Financial Reporting Requirements for Texas Public Community Colleges, Texas Higher Education Coordinating Board, Austin, TX.*

Codification of Governmental Accounting and Financial Reporting Standards, Governmental Accounting Standards Board, Norwalk, CT, 1998*

McDonald, Deirdre (ed.), *College and University Business Administration*, National Association of College and University Business Officers, Washington D.C., 1992.

* These resources are published on a periodic basis. The governing board, college, and external auditor should ensure they are using the latest version available.